

Internal Revenue Service
memorandum

CC:TL-N-8486-90

Brl:RLHarrigal

date: AUG 23 1990

to:

District Counsel, Denver CC:DEN

from:

Assistant Chief Counsel (Tax Litigation) CC:TL

subject:

[REDACTED]

This memorandum is in response to your request for tax litigation advice dated June 27, 1990.

ISSUE:

Whether under Treas. Reg. § 1.451-3(d)(5)(ii) which requires allocation of indirect costs that are "incident to and necessary for performance of particular long term contracts," the taxpayer, [REDACTED] must allocate to its contracts in process or completed in the tax year, certain costs not associated with any of the contracts performed during that year.
0451-1600

CONCLUSION:

We believe that the regulations do not contemplate the facts presented in this case. While the proper result under the regulations seems to be that all long term contracting costs should be allocated to long term contracts in progress or completed during the tax year, we believe, after discussions with representatives of the Assistant Chief Counsel, Income Tax and Accounting ("IT&A"), that we would have a difficult time finding support for this argument in the regulations because of the particular nature of the facts of this case. Accordingly, we recommend that this case be settled.

FACTS:

[REDACTED] is engaged in construction and uses the completed contract method of accounting for tax purposes. [REDACTED]'s contracts are "long term contracts," within the meaning of Treas. Reg. § 1.451-3(b)(1), as compared to extended period long term contracts, within the meaning of Treas. Reg. § 1.451-3(b)(3). [REDACTED] allocated its costs using the burden rate system.

09357

██████ incurred substantial costs, most of which are repair and maintenance costs, prior to the time that these costs could be associated with any presently allocable long term contract. Specifically, ██████ would purchase used equipment which would need to be repaired before it could be used in contracts and ██████ would purchase equipment not used in its current types of contracts in hopes of expanding into new types of contracts.

██████ has treated these unallocated costs as period costs--costs that are currently deductible. These deductions substantially exceeded income. The Service disallowed these deductions stating that these costs must be allocated to long term contracts performed by ██████ during the tax year. The Service cites as support for its disallowance, Treas. Reg. § 1.451-3(d)(5)(ii) which requires allocation of indirect costs "incident and necessary for the performance of particular long term contracts." The Service also notes that ██████'s method, even if it otherwise follows the above regulation, does not clearly reflect income.

Pursuant to an earlier request from the Denver Appeals Office for advice, IT&A sent a Technical Advice Memorandum (a copy of which is attached). In that memorandum, IT&A concluded that ██████ must include in the cost of contracts that are either in process or completed during a tax year, all indirect costs that are enumerated in Treas. Reg. § 1.451-3(d)(5)(ii) and that are incurred during the year. IT&A reasoned, using the analysis in McMaster v. Commissioner, 69 T.C. 952 (1978), that since the costs are sufficiently related to and benefit individual contracts, such costs must be allocated to long term contracts in progress despite the fact that they are not associated with particular long term contracts in progress.

IT&A also found that to the extent that there is a negative variance (because the taxpayer used the burden rate system, to the extent that the costs incurred exceeded the allocated costs, a negative variance would result), this variance must be treated in the same manner as the underlying costs. That is, the variance is to be allocated to long term contracts in process or completed in the year that the costs are incurred. Finally, IT&A addressed the penalty issue.

You have since requested further advice regarding IT&A's conclusion on allocating all indirect costs to contracts to which the costs do not relate. In particular, you were concerned with the "incident to and necessary for the performance of a particular contract" language in Treas. Reg. § 1.451-3(d)(5)(ii). After having some questions concerning IT&A's memorandum, we pursued the matter further with IT&A and they suggest (see enclosed memorandum), after reconsideration, that this case not be litigated. IT&A notes that 1) the regulations do not contemplate this situation, 2) the regulations imply that a

taxpayer will not incur long term contract costs without a related long term contract, 3) the position in the technical advice that all long term contracting cost should be allocated to long term contracts in progress is unduly harsh in light of the taxpayer's recent filing for bankruptcy, and 4) the issue is moot in light of changes in accounting for long term contracts under section 460.

DISCUSSION:

As a preliminary matter, it should be noted that the following analysis and conclusion apply only to noncapital costs. (It is our understanding that the vast majority of costs at issue are noncapital.) If the costs incurred were capital, then first, the amount of the expense must be capitalized. Treas. Reg. § 1.263(a)-1(b). If the equipment is thereafter idle, Treas. Reg. § 1.451-3(d)(5)(iii) provides that the depreciation (amortization or cost recovery allowance) is not attributable to long term contracts. Presumably then, the taxpayer could take the appropriate depreciation, etc., for the year. Treas. Reg. § 1.451-3(a)(3). If, however, the equipment is no longer idle, the depreciation, etc. is allocable to long term contracts. Treas. Reg. § 1.451-3(d)(5)(ii)(J). The issue here, however, is whether the noncapitalized costs are to be allocated under Treas. Reg. § 1.451-3(d)(5)(ii), and thus, "suspended," or whether they are immediately deductible as a period expense.

Section 451(a) includes in gross income for a taxable year any item received by the taxpayer unless the taxpayer, under its method of accounting, properly accounts for such item in a different period.

Income received from a long term contract may be accounted for under one of two long term contract methods: the percentage of completion or the completed contract method.¹ Treas. Reg. § 1.451-3(a). The method chosen must clearly reflect income. Treas. Reg. § 1.451-3(a). If the completed contract method is used, the gross contract price from the long term contract is

¹ The rules for long term contracts were changed in 1986. Since 1986, section 460 provides special rules for long term contracts. Section 460(c)(1) provides that for long term contracts all costs which directly benefit, or are incurred by reason of the long term contract activities of the taxpayer shall be allocated to such contract in the same manner as costs are allocated to extended period long term contracts and the regulations thereunder. I.R.C. § 460(c)(1). The long term contract method used by [REDACTED] is no longer available under section 460. Section 460 is not effective for contracts entered into before February 28, 1986. The contracts at issue were entered into before this date.

included in gross income in the tax year in which the contract is completed. Treas. Reg. § 1.451-3(d)(1). Additionally, costs properly allocable to a long term contract must be deducted from income in the tax year in which the contract is complete. Treas. Reg. § 1.451-3(d)(1).

Costs properly allocable to the contract include direct costs--direct material and direct labor costs--and indirect costs. Treas. Reg. § 1.451-3(d)(5). Indirect costs include all costs (other than direct labor and material costs) which are "incident to and necessary for the performance of particular long term contracts." Treas. Reg. § 1.451-3(d)(5)(ii). Section 1.451-3(d)(5)(ii) provides a nonexclusive list of items which are indirect costs. This list includes repair expenses of equipment used in the performance of particular long term contracts, and maintenance of equipment or facilities used in the performance of particular long term contract.

Notwithstanding the above, section 1.451-3(d)(5)(iii) lists costs which are not required to be attributed to long term contracts. This list also appears to be nonexclusive, nevertheless, there is some authority to suggest otherwise. See Treas. Reg. § 1.451-3(a)(3) (allocate all indirect costs other than those listed in Treas. Reg. § 1.451-3(d)(5)(iii)). This list includes depreciation, amortization and cost recovery allowances on equipment that has been placed in service, but is temporarily idle.

We believe that the regulations contemplate that while the long term contract method permits deferral of income from long term contracts until the contract is complete, deduction for expenses associated with such contracts should similarly be deferred. See Treas. Reg. § 1.451-3(a)(3); Treas. Reg. § 1.451-3(d); McMaster v. Commissioner, 69 T.C. 952 (1978). Consequently, if a taxpayer incurs expenses prior to entering into a contract, these expenses should be allocated to the contract to which they relate. McMaster, 69 T.C. 952.

The problem arises under the facts at issue since there are no contracts that relate to the costs in the year in which the costs are incurred. While McMaster holds that costs which antedate the contract must be allocated to the contract, the facts in McMaster do not indicate whether the costs at issue and the contracts to which they related were in different tax periods. Further, the costs in McMaster could be identified to a particular long term contract and it was to that contract to which these costs were attributed. In the facts at issue, the contract to which the costs related may not be entered into for several years.

The regulations provide no means to suspend these costs until the related contracts are executed. The only way to

suspend these noncapital costs under the regulations as enacted is to allocate these costs to contracts to which they do not relate. The regulations, however, provide that indirect costs which are allocable to long term contracts are those costs that are "incident to and necessary for the performance of particular long term contracts." Further, each item on the list of allocable indirect costs ends with the phrase "used in the performance of particular long term contracts."

In litigating the facts of [REDACTED] we would be required to argue that the aforementioned language in the regulations did not limit allocable costs to those costs that relate to contracts in progress or completed during the year. Instead, the regulations intended to include in allocable indirect costs all costs related to long term contracts (other than those costs listed in subsection (iii)). The regulations on their face seem to contradict this argument.

Indeed, if Treas. Reg. § 1.451-3(d)(5) is compared to Treas. Reg. § 1.451-3(d)(6), it would appear that such a broad interpretation of allocable costs is not what was intended. Treas. Reg. § 1.451-3(d)(6) allocates to extended period contracts indirect costs that directly benefit the performance of extended period long term contracts, or are incurred by reason of the performance of extended period long term contracts. In other words, Treas. Reg. § 1.451-3(d)(6) seems to include in allocable costs those type of costs that we would argue should be included in subsection (b)(5) of that same section.² But, subsection (b)(5) contains much more limiting language--"incident to or necessary for the performance of particular long term contracts."

Further, we could find no support for such a broad interpretation of subsection (b)(5). We would be limited to arguing, despite the narrower language in subsection (b)(5), as compared to subsection (b)(6), that the intent of the regulations was to postpone deduction of costs associated with a long term contract until the contract is complete (the matching of income and expenses).

The facts in the case at issue make even this argument difficult. [REDACTED] is now out of business and presumably, some of the costs that would be allocated to long term contracts will never relate to a long term contract in particular.

Given these concerns and given IT&A's revised recommendation, we believe that this case is not the vehicle to litigate our position on the regulations and, thus, we recommend

² Treas. Reg. § 1.451-3(d)(6)(ii) in listing the allocable costs uses the phrase "used in the performance of particular extended period long term contracts."

that this case be settled. It is our understanding that the taxpayer is anxious to settle this case. As the Technical Advice Memorandum does not set forth the arguments for a broad interpretation of the "incident to and necessary for the performance of particular long term contracts" language, we would be happy to address these arguments, in the event the case is not settled.

If you have any further questions, please contact Rebecca L. Harrigal at FTS 566-4189.

MARLENE GROSS

By: Richard L. Carlisle
RICHARD L. CARLISLE
Senior Technician Reviewer
Branch No. 1
Tax Litigation Division

Attachments:

Technical Advice Memorandum dated May 4, 1989
Memorandum from Associate Chief Counsel, Income Tax and
Accounting, undated